**Office of Chief Counsel**
**Internal Revenue Service**

# memorandum

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JEKagy

**date:**

**to:** Chief, Examination Division, Ohio District
Attn: Lowell Collins (E:EB1:1101)

**from:** Assistant District Counsel, Ohio District, Cincinnati

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**subject:** [redacted]
**Recognizing Lease Origination and Processing Fees as Income**

On June 2, 2000, Lowell Collins met with Ohio District Counsel to discuss a lease origination fee issue involving the taxpayer referenced above. Mr. Collins asked us to address two areas of concern. First, we were asked to consider the legitimacy of the methodology used by Examination to determine the size of the proposed adjustment. Second, we were asked to opine on the litigation potential of the underlying legal position upon which the adjustment is based.

As described by Mr. Collins during the June 2nd meeting, the proposed adjustment seeks to require the taxpayer to accrue and report as income the full amount of the origination fees and costs incurred in generating its automobile leases. To propose such an adjustment, it is necessary generally to determine the number of leases generated by the taxpayer on a year by year basis and the fees and costs incurred in generating those leases. At a minimum, the Service must have credible documentary evidence to establish the actual amount of fees earned and costs incurred in generating the leases closed in any taxable period.

The methodology employed by the Service to compute the adjustment, however, does not determine the actual number of leases shown on the taxpayer's books and determines neither the actual costs incurred by the taxpayer nor the actual fees resulting from the leases closed in the tax period at issue. Instead, the Service's methodology is based on an estimate of the number of leases in existence in the year at issue and an estimate of the average fees and costs associated with those leases. The Service's methodology computes its estimate of the total fees and costs by multiplying the estimated average cost per lease times the estimated number of leases closed the given year. The proposed adjustment is then calculated by multiplying the estimated total fees and costs associated with the projected

leases by a calculated percentage. Moreover, the calculated percentage utilized is determined by using projections which are based on a statistically invalid sample culled from leases which closed in a year other than the year at issue. More specifically, less than ten leases were examined out of an estimated 33,000 leases originating each year. The sample is simply too small to support any meaningful conclusions. In addition, while the proposed adjustment deals with the [redacted] tax year, the leases examined originated in the [redacted] tax year. Since the pool from which the observations were culled did not include the [redacted] transactions, even if the conclusions drawn were valid, there is no discernable connection between the conclusions reached regarding the [redacted] tax year observations selected and leases originating in the [redacted] tax year. ***As we opined at the June 2nd meeting, the Service's current methodology is unsupportable in litigation.***

We have been informed by Mr. Collins that he will attempt to work with the taxpayer to obtain sufficient data from which the agents can accurately determine the actual number of leases in existence on a year by year basis, the actual fees associated with those leases, and a valid statistical sample from which projections can be generated. Given the forgoing, we will not address the methodology issue any further. We withhold any opinion regarding the propriety of the methodology ultimately utilized by the Service until we have the opportunity to review that methodology.

As to the second issue regarding the litigation potential of the underlying issue, we need additional information before we can respond to your inquiry. As we understand your issue, you propose to require the taxpayer to recognize income equal to the lease origination fees and costs associated with the four-year or longer leases generated in each year, although adjusted for leases retired early, extended, or written off as uncollectible.

Cited as authority for the Service's position are the decisions of Columbia State Savings Bank v. Commissioner, 41 F.2d 923 (7th Cir. 1930); Metropolitan Mortgage Fund, Inc. v. Commissioner, 62 T.C. 110 (1970); and PNC Bancorp, Inc. v. Commissioner, 110 T.C. 349 (1998)[1]. As it currently stands, the Service's position is that the cited cases collectively stand for the proposition that loan origination fees and expenses incurred by banks making long-term, home mortgage loans must be recognized

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[1] PNC Bank was reversed by the Third Circuit in an opinion dated May 19, 2000. We attach a copy of the Third Circuit's opinion for your reading.

as income by accrual method lenders in the year of the loan. Moreover, as applied to the subject taxpayer, the Service proposes to require the similar recognition of income equal to the origination fees and costs associated with automobile leases closed by the taxpayer during the tax year.

Without addressing the significance and effect of the reversal of the PNC opinion, we note that the cases cited involve the tax accounting necessary for fees incurred in making long-term real estate loans or home loans, not relatively short-term automobile leases. We also note that no cases decided to date address whether, for tax accounting purposes, fees incurred in making four-year (or longer) leases must be recognized in the year the lease closes.

The cases cited by the agent discuss in some detail: (1) how the loans made by these particular banks work, (2) how the loans have historically been treated by the banking industry for both tax and book purposes, (3) the accounting standards required of financial institutions within the banking industry, (4) the standards applied to other industries, and (5) how other banks treat similar loans.

The significance of the factual matters in the cited cases suggests that similar factual questions likely will be equally important to the lease expense issue currently under contemplation. Moreover, since there are no cases in which lease origination fees and costs have been addressed, to be successful in the proposed issue, the Service must be able to convince the court that the loan fee cases should also control lease fee cases. That position, in turn, may depend on whether the Service can successfully establish that there either are no significant differences between loan fees and costs and lease fees and costs and that any differences which do exist are inconsequential. These are all factual determinations under the District Director's jurisdiction.

From the material you provided so far, we are unable to determine any real specifics about the subject leases. Without attempting to be exhaustive, we have set forth below some of the items which we were unable to determine from the limited facts you have sent to us:

(1) the terms and conditions of the leases offered by the taxpayer,
(2) how those terms and conditions differ from industry norms,
(3) the steps which must be taken by the banks to generate an automobile lease,

(4) the full scope of the activities for which fees are being generated,
(5) who actually incurred the costs at issue,
(6) which costs are labeled fees as opposed to those labeled costs,
(7) whether any of the fees or costs were paid up front by the lessee,
(8) whether the costs at issue were either universally or occasionally rolled into the lease payment, and if so, how did that affect the lease payments,
(9) how the leases of this particular bank work,
(10) how automobile leases have historically been treated by the banking industry for both tax and book purposes,
(11) how the accounting standards which apply to the banking industry apply to leases,
(12) how the accounting standards which apply to other industries apply to leases,
(13) how other banks treat similar leases,
(14) whether these leases differ from other banks' leases and, if so, how,
(15) how this bank treats the expenses associated with leases which are not finalized, and
(16) how the Service is currently treating and has historically treated short-term leases held by other banks, credit unions, savings and loans and other financial institutions.

We understand that the taxpayer has already suggested informally that, at least as a general rule, 4-year automobile leases are inherently different from the long-term real estate loans discussed in the cited court cases. It is imperative that we know as much about the leases as is possible. Without that factual knowledge, it will be impossible to determine the similarities and differences between the loans discussed in the court cases and the leases at issue and we will be unable to accurately advise you regarding the litigation strengths and weaknesses of the issue you propose.

Factually, you need to commit to paper your understanding of the facts as they apply to this taxpayer and supply us with the documentation upon which you rely for those factual statements. *At a minimum,* your factual summary should address the questions outlined above, and we also suggest that you include all other facts relevant to the issue which your examination has determined. Further, to the extent that you have discussed this issue with our counterparts in National Office or with one or more ISP Industry Specialists, we need to know the names of the persons with whom you spoke, the dates of your conversations, if

possible, and, to the extent you know, the telephone number of each individual with whom you spoke.

Because of the lack of either case law or National Office guidance regarding the proper tax accounting for the costs and fees associated with relatively short-term automobile leases, we anticipate that this issue, once factually developed, will need to be sent to the National Office for Field Service Advice.

If you have questions regarding this memorandum, please contact the undersigned at 684-3211, at your convenience.

MATTHEW J. FRITZ
*Assistant District Counsel*

By: _____
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